INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statutes involved	2
Statement	3
Summary of argument	5
Argument:	
Depreciation on equipment owned and used by a taxpayer in constructing its capital facilities is a nondeductible cost of construction which must be capitalized as part of the adjusted basis of those facilities	8
1. Normal accounting rules and elementary principles of federal tax accounting require capitalization of construction-related depreciation	8
a. Introduction	8
b. Underlying economic and accounting considerations support the government's position in this case	10
2. Capitalization of respondent's construction-related depreciation is required by Section 263 of the Code	15

Argument—Continued Page

a. Section 263 governs transactions to which both it and Section 167 by their literal terms apply 16

b. Construction-related depreciation is an "amount paid out" within the meaning of Section 263 20

Conclusion 25

CITATIONS

Cases:

All-Steel Equipment, Inc. v. *Commissioner*, 54 T.C. 1749, reversed in part, 467 F. 2d 1184 ..... 17, 18

American Automobile Association v. *United States*, 367 U.S. 687 14

Brooks v. *Commissioner*, 50 T.C. 927, reversed on other grounds, 424 F. 2d 116 ..... 22, 23

Brown v. *Helvering*, 291 U.S. 193 15

Chicago, R.I. & P. Ry. Co. v. *Commissioner*, 13 B.T.A. 988, reversed as to other issues, 47 F. 2d 990 22

Commissioner v. *Glenshaw Glass Co.*, 348 U.S. 426 14

Commissioner v. *Hansen*, 360 U.S. 446 15

Commisioner v. *Lincoln Savings & Loan Ass'n*, 403 U.S. 345 ..... 13-14, 15, 21

Coors v. *Commissioner*, 60 T.C. 368 22

Gordon v. *Commissioner*, 37 T.C. 986 24

Cases—Continued Page

Great Northern Ry. Co. v. *Commissioner*, 8 B.T.A. 225, affirmed, 40 F. 2d 372, certiorari denied, 282 U.S. 855 ..... 10, 22
Great Northern Railway Co. v. *Commissioner*, 30 B.T.A. 691 22
Gulf, M. & N. R. Co. v. *Commissioner*, 22 B.T.A. 233, affirmed as to other issues, 71 F. 2d 953 22
Helvering v. *Clifford*, 309 U.S. 331 14
Hertz Corp. v. *United States*, 364 U.S. 122 12
James v. *United States*, 366 U.S. 213 14
Missouri Pacific R. Co. v. *Commissioner*, 22 B.T.A. 267 22
Mitchell v. *Commissioner*, 42 T.C. 953 24
North America Oil Consolidated v. *Burnet*, 286 U.S. 417 14
Orr v. *United States*, 343 F. 2d 553 24
Producers Chemical Co. v. *Commissioner*, 50 T.C. 940 ..... 22, 24
Schlude v. *Commissioner*, 372 U.S. 128 14
Southern Natural Gas Co. v. *United States*, 412 F. 2d 1222 22
United States v. *Mississippi Chemical Corp.*, 405 U.S. 298 18
Woodward v. *Commissioner*, 397 U.S. 572 10

Statutes and regulations:

Internal Revenue Code of 1954 (26 U.S.C.):
Sec. 161 ..... 2, 6, 17, 18
Sec. 162 16
Sec. 162-188 18

Statutes and regulations—Continued Page

Sec. 163 18
Sec. 164 18
Sec. 165 18
Sec. 167 ..... 2, 6, 15, 16, 17, 20, 25
Sec. 170 ..... 7, 23, 24, 25
Sec. 174 18
Sec. 213 ..... 7, 23, 24, 25
Sec. 261-279 ..... 17, 18
Sec. 263 ..... 2, 4, 5, 6, 7, 15, 16, 17, 20, 21, 23, 24
Sec. 263(a)(1)(A) 19
Sec. 263(a)(1)(B) 17, 19
Sec. 263(a)(1)(E) 18
Sec. 263(a)(1)(A)-(E), (c) and (d) 19
Sec. 266 ..... 17, 19
Sec. 441(c) 13
Sec. 446 ..... 13, 21
Sec. 461(a) 13

26 C.F.R. 1.61-3(a) 18
26 C.F.R. 1.263(a)-2(a) 10, 16, 21-22

Miscellaneous:

Finney & Miller, *Principles of Accounting—Introductory* 246-247 (6th ed.) 11
H. Rep. No. 586, 82d Cong., 1st Sess. 19
H. Rep. No. 1337, 83d Cong., 2d Sess. 19, 20
Paton, *Asset Accounting: An Intermediate Course* 192-193 (1st ed.) 11
Rev. Rul. 55-252, 1955-1 Cum. Bull. 319 22
Rev. Rul. 59-380, 1959-2 Cum. Bull. 87 22
S. Rep. No. 1881, 87th Cong., 2d Sess., 338 19

In the Supreme Court of the United States

OCTOBER TERM, 1973

No. 73-263

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

IDAHO POWER COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The memorandum findings of fact and opinion of the Tax Court (Pet. App. 10-19) are not officially reported; they are unofficially reported at 29 T.C.M. 383. The opinion of the court of appeals (Pet. App. 20-37) is reported at 477 F. 2d 688.

JURISDICTION

The judgment of the court of appeals (Pet. App. 38) was entered on April 10, 1973. On July 5, 1973, Mr. Justice Douglas extended the time for filing a

petition for certiorari to and including August 8, 1973. The petition was filed on that date and was granted on November 5, 1973. The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether depreciation on equipment owned and used by a taxpayer in constructing its capital facilities is a nondeductible cost of construction which must be capitalized as part of the adjusted basis of those facilities.

STATUTES INVOLVED

Sections 161, 167, and 263 of the Internal Revenue Code of 1954, 26 U.S.C. 161, 167, and 263, provide in pertinent part as follows:

> Section 161. In computing taxable income * * *, there shall be allowed as deductions the items specified in this part [Sections 161 through 188], subject to the exceptions provided in Part IX (sec. 261 and following, relating to items not deductible).
>
> Section 167(a). There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear * * * of property used in the trade or business * * *.
>
> Section 263(a). No deduction shall be allowed for—
>
> (1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. * * *

STATEMENT

Respondent is a public utility company engaged in the production, transmission, distribution and sale of electric energy.[1] In connection with its principal business, respondent constructs additions and improvements to its capital facilities, using its own employees and equipment. The major construction work consists of additions to or improvements in transmission lines, transmission switching stations, distribution lines, distribution stations, and connecting facilities. During the two years in question, 1962 and 1963, respondent expended over $12,000,000 on construction work of this kind. At the time of the trial in this case, respondent had 140 employees working on new construction.

In performing this construction work, respondent used a wide variety of automotive transportation equipment, including passenger cars, trucks of all description, power operated equipment and trailers, and so forth. For its general accounting purposes, including reporting to regulatory agencies responsible for ratemaking and other related determinations, respondent treated the depreciation on this equipment, to the extent it was used in construction, as part of the cost of the capital facilities so constructed. Thus for accounting purposes the depreciation was capitalized and then amortized over the life of

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[1] The facts recited herein are taken from the Tax Court's memorandum findings of fact (Pet. App. 10-13).

the capital facilities.[2] For tax purposes, however, respondent treated this construction-related depreciation not as a capital expenditure but as a currently deductible item of expense. The amount of depreciation here at issue is $150,047.42 for 1962 and $130,523.99 for 1963.

The Commissioner determined that the construction-related depreciation on respondent's equipment was a nondeductible capital expenditure under Section 263 of the Internal Revenue Code of 1954, 26 U.S.C. 263, and adjusted respondent's federal income tax returns accordingly. He disallowed deductions for construction-related depreciation, added the amount of the disallowed depreciation to respondent's adjusted basis in its capital facilities, and allowed additional depreciation with respect to those facilities on account of the increase in their adjusted basis. The net effect of these adjustments was to increase respondent's tax liability for 1962 by $73,023.47 and for 1963 by $50,342.21.

The Tax Court sustained the Commissioner's determination (Pet. App. A). The court of appeals reversed (Pet. App. B), apparently reasoning that Section 263 of the Code does not apply to items spe-

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[2] Respondent also capitalized substantially all the costs of operating and maintaining the construction equipment, including the wages paid to operators, the cost of fuel, and so forth, as well as the wages of other construction employees and the cost of tools and other materials wholly consumed in the course of construction. Respondent does not contest the propriety of treating these items as nondeductible capital expenditures for tax purposes.

cifically made deductible by other Code provisions and that, in any event, construction-related depreciation is not the kind of capital expenditure which Section 263 requires to be capitalized.

SUMMARY OF ARGUMENT

1. Both good accounting practice and basic tax accounting principles require that the costs incurred in acquiring a long-lived, income-producing asset be capitalized rather than taken as a current deduction. Immediate deduction of such costs would seriously distort the reporting of income. Capitalization, together with amortization over the asset's useful life, permits a reasonable allocation of the asset's cost over the periods during which it contributes to the production of income.

Capitalization of asset acquisition costs is required whether the asset is purchased or constructed by the taxpayer itself. Since the depreciation incurred on construction equipment is part of the cost of constructing a new capital facility, normal accounting rules require capitalization of that depreciation. The reason for this is that such depreciation is not related to the immediate production of income, but only to the production of income over the life of the newly constructed asset. Respondent, in claiming an immediate deduction for such depreciation, is in effect contending that it is permitted under the Internal Revenue Code to postpone the recognition of net income earned currently by taking, as a deduction against such income, an item of depreciation expense

to which it is not entitled under normal accounting rules. That contention may be sustained only if supported by compelling statutory language or fundamental considerations of tax policy. There is no such support for respondent's position.

2. The statutory provisions governing this case are Section 263, embodying the principle of capitalization, Section 167, allowing a deduction for depreciation, and Section 161, which gives Section 263 priority over Section 167 whenever those two provisions otherwise appear to conflict.

a. The court of appeals below erred in holding that Section 263 only applies to capital items whose deductibility is not allowed under some other express provision of the Code. Section 161 provides in clear terms that all business-related deductions, including the deduction for depreciation, are subject to, *inter alia*, the capitalization requirement of Section 263. The court of appeals simply overlooked the mandatory language of Section 161.

The priority ordered by Section 161 is not accidental. That priority—which requires capitalization of depreciation incurred in connection with the acquisition of capital assets—merely insures that the tax and accounting treatment of such depreciation will be alike. Moreover, Congress has often manifested its awareness that construction-related depreciation is nondeductible under the Code, and it has taken care, in amending Section 263, to make only narrow exceptions to that broad rule.

b. Section 263 expressly prohibits a deduction for any "amount paid out for new buildings or for per-

manent improvements or betterments * * *." The court of appeals below held that construction-related depreciation is not an "amount paid out" within the meaning of that provision. This holding exhibits a fundamental misunderstanding of the purpose of Section 263. That purpose is to state the broad principle that capital expenditures may not be deducted currently; Section 263 must therefore be read expansively as the legislative expression of the basic principle of capitalization. The Internal Revenue Service and the courts charged with special responsibility for interpreting and applying the federal tax laws have long applied that principle to construction-related depreciation.

Furthermore, depreciation clearly represents an "amount paid out." When respondent purchased its construction equipment, amounts were paid out; depreciation allocates those amounts over several accounting periods. Depreciation, therefore, stands on the same footing as other costs which were actually paid out in an earlier or later year—like the cost of materials purchased in an earlier year but wholly consumed by construction activities during the taxable year, or the cost of construction workers' wages accrued but not yet paid during the taxable year. Section 263 makes no reference to the timing of actual payment; the emphasis of the statute is on the ultimately capital nature of the expenditure. Thus cases disallowing depreciation under Sections 170 and 213, which require payment "during the taxable year," are irrelevant to the issue here.

ARGUMENT

DEPRECIATION ON EQUIPMENT OWNED AND USED BY A TAXPAYER IN CONSTRUCTING ITS CAPITAL FACILITIES IS A NONDEDUCTIBLE COST OF CONSTRUCTION WHICH MUST BE CAPITALIZED AS PART OF THE ADJUSTED BASIS OF THOSE FACILITIES.

1. Normal Accounting Rules and Elementary Principles of Federal Tax Accounting Require Capitalization of Construction-Related Depreciation.

a. *Introduction.* This case raises an important question concerning the proper application of two fundamental and interrelated accounting concepts, capitalization and depreciation, under the Internal Revenue Code of 1954. Together, capitalization and depreciation govern the accounting treatment of long-lived, income-producing assets. The purpose of capitalization is to prevent the distortion in the reporting of net income which would result from permitting the immediate deduction, as an expense of doing business, of the acquisition costs of assets used for the production of income in two or more accounting periods. Thus, for example, when respondent purchases automotive equipment the purchase price is capitalized on its books.

As assets are physically used up they typically become less valuable. The physical "using up" of an asset constitutes a real cost to a business, for part of its capital is being consumed. Depreciation is an accounting device which recognizes this cost by reducing the basis of the asset on the business' books as it is used up. The amount by which the asset basis is reduced—*i.e.*, the depreciation—is normally taken as an

expense against income. Indeed, the major purpose of depreciation accounting is to allocate the expense of using up an asset to the accounting periods during which that use is associated with the production of income. Thus the taking of an immediate expense deduction for depreciation is proper where the using up of the asset has contributed to the production of current income.

Assets are not always used, however, for the immediate production of income. Our position in this case is that where the using up of assets, or depreciation, is incurred not for the immediate production of income but instead for the construction of additional assets which will themselves be used for the production of income in the future, a deduction of the depreciation against current income is inappropriate. The physical using up of the equipment is not a cost of producing current income; it is a cost of constructing a capital facility.

Both respondent and the government agree that the adjusted basis of respondent's construction equipment should be reduced on account of depreciation. But unlike respondent, we believe that the amount of the depreciation should be added to the adjusted basis of the capital facilities respondent builds with that equipment and should not be taken as an immediate deduction.[3] We now discuss in greater detail the economic

[3] An example may make this proposition clearer. Assume respondent purchases a truck having a useful life of five years at a cost of $10,000 and that the straight-line method of depreciation is employed. Assume further that during the first year the truck is used exclusively in construction work.

and accounting considerations which underlie our position here.

b. *Underlying economic and accounting considerations support the government's position in this case.* Both good accounting practice and elementary principles of federal tax accounting require capitalization of the cost incurred in acquiring long-lived, income-producing assets. As this Court noted in *Woodward* v. *Commissioner*, 397 U.S. 572, 575, "[i]t has long been recognized * * * that costs incurred in the acquisition * * * of a capital asset are to be treated as capital expenditures." While this principle is most frequently applied to the purchase of a capital asset, capitalization is also required when costs are incurred by a business in constructing its own capital facilities. Indeed, it has long been established under the federal tax laws that a taxpayer's construction costs must be capitalized and are not immediately deductible when incurred. See, *e.g.*, *Great Northern Ry. Co.* v. *Commissioner*, 8 B.T.A. 225, 260-263, affirmed, 40 F. 2d 372 (C.A. 8), certiorari denied, 282 U.S. 855. See, also, 26 C.F.R. 1.263(a)-2(a).

The application of this general principle is clear with respect to expenditures such as wage payments to construction workers and the purchase cost of construction materials. Although wages are normally deductible as items of expense, they must be capital-

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Respondent and the government agree that a depreciation allowance of $2000 is appropriate, reducing the adjusted basis of the truck to $8000. Respondent would deduct that $2000 allowance against current income; we would add it to the adjusted basis of the facility under construction and permit it to be amortized as an expense over the useful life of that facility.

ized when they are paid in connection with the construction or other acquisition of capital assets. The reason for this treatment is evident: the money expended in the payment of construction wages is not an expense associated with the current production of income; it is an investment in an asset which will be used to produce income in the future, and therefore must be allocated as an expense over future accounting periods. Other construction expenditures which might at first blush be regarded as normal operating expenses, such as the cost of operating and maintaining construction equipment, must also be capitalized. Respondent and the government are in general agreement with respect to the proper accounting and tax treatment of such items (see note 2, *supra*).

But good accounting practice also requires capitalization of certain other intangible construction costs, including the allowance for the wear and tear, or depreciation, of the equipment used in the course of construction. See, *e.g.*, Paton, *Asset Accounting: An Intermediate Course* 192-193 (1st ed.); Finney & Miller, *Principles of Accounting—Introductory* 246-247 (6th ed.). As we indicated above, depreciation recognizes the cost of using up an asset; construction equipment is used up, and a cost thereby incurred, during construction. Construction-related depreciation represents that cost and as such it is simply one more item of cost incurred in acquiring a particular capital facility. Such depreciation therefore does not represent an expense of doing business; it is, rather, the transfer of an investment in equipment into an

investment in plant facilities. This fact is properly accounted for on a business' books by capitalizing construction-related depreciation, *i.e.*, by reducing the equipment account, and increasing the capital facility account, by the amount of the depreciation. In this sense, capitalization is necessary as a matter of proper asset accounting.

But, more importantly, capitalization of construction-related depreciation is also necessary to prevent the improper reduction of net income which would result from the deduction of an item of expenditure that is not associated with the current production of income. The basic purpose of depreciation accounting is to "allocate the expense of using an asset to the various periods which are benefited" by its use. *Hertz Corp.* v. *United States*, 364 U.S. 122, 126. Thus, for example, if automotive equipment is used in connection with the immediate production of income, as in hauling goods to the market, the depreciation on that equipment is properly deductible when incurred. But if that automotive equipment is used instead in the construction of capital facilities, its use renders no income-producing benefit to the immediate accounting period. Like the cost of wage payments to construction workers, construction-related depreciation is associated with the production of income not when it is incurred but only over the useful life of the newly constructed capital facility.

Thus the periods benefited by a business' use of equipment to construct its own capital facilities are those during which the facilities so constructed are

themselves used for the production of income. The proper matching of items of income and expense is therefore achieved only by capitalizing construction-related depreciation as part of the cost of the new capital facilities and then amortizing that cost over the life of those facilities.

For these reasons, both the Federal Power Commission and the Idaho Public Utilities Commission require respondent to capitalize construction-related depreciation in its reports to them, and respondent keeps its own books on the same basis (Pet. App. 12, 22). Moreover, respondent apparently concedes that this procedure is required by generally accepted accounting principles (Resp. Br. in Opp. 6). Respondent contends that it is nevertheless entitled to an immediate deduction of construction-related depreciation under the Internal Revenue Code. Viewed in context, therefore, respondent's contention is that it is permitted under the Code to defer the recognition of net income by taking a depreciation deduction to which it is not entitled under normal accounting rules.

In making this contention, respondent apparently suggests (Resp. Br. in Opp. 6) that general principles of accounting are irrelevant to the concept of taxable income under the Code. But Section 446 of the Code, which requires taxable income to be computed under a method of accounting that "clearly reflect[s] income," implicates accounting principles. See, also, Sections 441(c) and 461(a). Moreover, this Court noted in *Commissioner* v. *Lincoln Savings*

& Loan Ass'n, 403 U.S. 345, 355, that a taxpayer's own accounting practices and those of its regulating authority are significant in assessing the proper tax treatment to be given a transaction.

This is not, of course, to say that the determination of taxable income is governed in all cases by accounting principles. Many provisions of the Code expressly permit or require a deviation from such principles. In other circumstances, overriding considerations of tax policy have led this Court to interpret "income," as used in the Code, in a manner apart from its meaning to accountants.

Thus in *Schlude* v. *Commissioner*, 372 U.S. 128, and *American Automobile Association* v. *United States*, 367 U.S. 687, this Court held that a taxpayer may not defer the reporting of cash receipts as gross income, even if those receipts were not yet income in an accounting sense. In those cases, the taxpayers had untrammeled possession of monies held without restriction as to their disposition and without liability for repayment. In holding the receipt of such monies to be taxable, this Court gave due recognition to the fact that Congress intended, in defining gross income, "to use the full measure of its taxing power." *Helvering* v. *Clifford*, 309 U.S. 331, 334. See, also, *James* v. *United States*, 366 U.S. 213; *Commissioner* v. *Glenshaw Glass Co.*, 348 U.S. 426; *North American Oil Consolidated* v. *Burnet*, 286 U.S. 417. Similarly, though accounting practice in many cases sanctions, or even requires, the anticipation of losses or expenses by the establishment of reserves, such uncertain and unascertained items are not deductible

for tax purposes (*e.g.*, *Brown* v. *Helvering*, 291 U.S. 193), except where specifically authorized by statute.

But where neither compelling statutory language, fundamental tax policy considerations, nor practical necessities of administration require otherwise, the process of income-determination under the Code is generally informed by normal accounting rules. See, *e.g.*, *Commissioner* v. *Lincoln Savings & Loan Ass'n*, *supra*; *Commissioner* v. *Hansen*, 360 U.S. 446. Certainly this is true where, as in the case of construction-related depreciation, normal accounting rules accurately reflect economic substance and would require postponement in the taking of a deduction. A strong showing of unambiguous statutory authority should be required of a taxpayer who claims the right to defer the recognition of net income by taking a current deduction not sanctioned by normal accounting rules. As we now demonstrate, there is no such authority for the deduction respondent here claims.

2. Capitalization of Respondent's Construction-Related Depreciation Is Required by Section 263 of the Code.

The accounting principles of capitalization and depreciation are represented in the Internal Revenue Code by Sections 263 and 167, respectively. Section 263 provides that "[n]o deduction shall be allowed for * * * [a]ny amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate." Thus Section 263 prohibits an immediate deduction for the costs of assets having a useful life of more than one year and thereby prevents a taxpayer from anticipating deductions properly attribu-

table to the later years when the assets are used in the production of income. Section 167 permits the deduction of a "reasonable allowance for the exhaustion, wear and tear" of property arising out of its use or employment in the business. Thus Section 167 provides for a reasonable allocation, over subsequent taxable years, of the cost which Section 263 requires to be capitalized in the first year.

a. *Section 263 governs transactions to which both it and Section 167 by their literal terms apply.* When depreciable equipment is used in the construction of capital facilities, Sections 263 and 167, read in isolation, appear to point to conflicting tax results. Section 263 requires capitalization of the "cost of acquisition, construction, or erection of buildings * * * and similar property * * *." Treasury Regulations, 26 C.F.R. 1.263(a)-2(a). Since construction-related depreciation is a cost of construction, Section 263 points to nondeductibility. On the other hand, Section 167 by its terms would appear to allow a deduction for any depreciation on income-producing property, whether or not construction-related. The court of appeals resolved this apparent conflict in favor of immediate deductibility, holding that Section 263 does not bar deductions specifically allowed elsewhere in the Code.[4]

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[4] The court's holding, if pursued to its logical conclusion, would appear to permit the deduction of all construction-related expenses, including wages paid to construction workers, for Section 162 specifically permits the deduction of ordinary and necessary business expenses, including wages. Presumably the court did not intend that result. But its analysis of the statutory text offers no reason why Section

That holding is contrary to the explicit language of the statute. Congress has stipulated, in unmistakable terms, the manner in which the apparently conflicting provisions of Sections 263 and 167 are to be reconciled: Section 161 makes all business-related deductions, including the deduction for depreciation under Section 167, "subject to the exceptions provided in [Sections 261 through 279]." Thus whenever Sections 263 and 167 appear to point to conflicting results, it is Section 263 which controls. In holding otherwise, the court below simply overlooked the plain language of Section 161.

In holding that Section 263 is inapplicable to deductions otherwise specifically allowed by the Code, the court of appeals relied solely on *All-Steel Equipment, Inc.* v. *Commissioner*, 54 T.C. 1749, reversed in part, 467 F. 2d 1184 (C.A. 7). In that case, the Tax Court held that taxes, losses, and research and experimental expenses incurred in producing items for inventory are currently deductible and need not be capitalized as part of the cost of inventory.[5] We do not here dispute the correctness of that result. Section 263(a)(1)(B) exempts research and experimental expenses from the broad capitalization re-

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263 would bar business expense deductions under Section 162 but not depreciation deductions under Section 167.

[5] The Tax Court also held that certain repair expenses incurred in producing inventory could be currently deducted rather than included in inventory cost as contended by the Commissioner. The court of appeals reversed that determination, holding (467 F. 2d at 1186) that the repair expenses could be deducted "only in the taxable year in which the manufactured goods to which the repairs relate are sold."

quirement of that Section; Section 266 creates a further exception to Section 263 by granting taxpayers the option of either capitalizing or deducting taxes otherwise attributable to a capital account; and the Treasury Regulations (26 C.F.R. 1.61-3(a)) have long provided that losses are not properly includible in inventory.

We do, however, disagree with the Tax Court's broad statement in that case that "deductions expressly granted by statute [*i.e.*, Sections 164, (taxes), 165 (losses), and 174 (research costs)] are not to be deferred even though they relate to inventory or capital items." 54 T.C. at 1759. That statement is inconsistent not only with Section 161, which expressly makes Sections 162-188 subordinate to Sections 261-279, but also, of course, with the subsequent decision by the Tax Court in the present case. See, also, *United States* v. *Mississippi Chemical Corp.*, 405 U.S. 298 (involving capitalization of expenditures which the taxpayer sought to deduct as interest payments under Section 163). Like the court of appeals below, the Tax Court in *All-Steel Equipment* simply overlooked Section 161.

Moreover, the language of Section 161, as it bears upon construction-related depreciation, is not a product of inadvertence. The priority ordered by Section 161 accords with generally accepted accounting principles. Furthermore, Congress has often manifested its awareness that construction-related depreciation is nondeductible under the Code.

For example, in recommending enactment of Section 263(a)(1)(E), permitting the deduction of

farmers' land-clearing expenditures, the Senate Finance Committee noted that under the new Act, farmers would be permitted to deduct "a reasonable allowance for depreciation with respect to property which is used in the clearing of land for the purpose of making such land suitable for use in farming * * * [whereas] [u]nder present law such depreciation must be capitalized." S. Rep. No. 1881, 87th Cong., 2d Sess. 338. In enacting Section 263(a)(1)(B), permitting the deduction of research and experimental expenditures, and the predecessor of Section 263(a)(1)(A), permitting the deduction of certain expenditures incurred in the development of mines or deposits, Congress also expressed its intention of granting only narrowly limited exceptions to the general rule that construction-related depreciation is nondeductible. See H. Rep. No. 1337, 83d Cong., 2d Sess. 28, A57-A59; H. Rep. No. 586, 82d Cong., 1st Sess. 31.

Congress, then, has long been aware that the language of the Code requires capitalization of construction-related depreciation. It is therefore highly significant that Congress, in creating certain exceptions to the broad requirement that capital costs be capitalized (see, *e.g.*, Section 263(a)(1)(A)-(E), (c) and (d), and Section 266), has chosen not to enact such an exception for construction-related depreciation generally. The court of appeals below has therefore sanctioned an immediate deduction not allowed by normal accounting rules, and consequently a deferral in the recognition of taxable income, which the Congress has steadfastly refused to permit.

The court purported to draw support for this result from the 1954 liberalization of tax depreciation rules under Section 167. But those liberalized rules, which permit the adoption of methods of accelerated depreciation accounting, are not at issue here; there is no question here concerning the amount of depreciation properly chargeable to respondent's construction equipment. The issue here is simply whether that depreciation is currently deductible or must be capitalized as a cost of construction.

In adopting liberalized depreciation rules, Congress was not sanctioning the deductibility of depreciation which Section 263 requires to be capitalized. Had that been the Congressional purpose, it could have easily manifested that purpose by proper amendment to Section 263; that, however, is precisely what Congress has refused to do. Moreover, in designing liberalized depreciation rules, Congress intended only to "give the economy added stimulus and resilience *without departing from realistic standards of depreciation accouting.*" H. Rep. No. 1337, 83d Cong., 2d Sess. 24 (emphasis added). As we have shown (pp. 10-15, *supra*), normal accounting rules, including "realistic standards of depreciation accounting," require the capitalization of construction-related depreciation.

b. *Construction-related depreciation is an "amount paid out" within the meaning of Section 263.* The court of appeals alternatively reasoned that construction-related depreciation is not an "amount paid out" within the meaning of Section 263. Apparently the court read Section 263 as requiring capitalization

only of actual transfers of funds taking place within the taxable year. This reading is wrong for several reasons.

At the most fundamental level, that narrow reading of the statute exhibits a basic misunderstanding of the purpose of Section 263. That purpose is to state the broad principle of capitalization, *i.e.*, that capital expenditures may not be immediately deducted. Section 263 therefore is not a technical section to be read narrowly. If its purpose is to be fairly achieved, Section 263 must be read expansively as the legislative expression of the principle of capitalization.*

This is the long-standing administrative construction of the statute: the Treasury Regulations state broadly that nondeductibility under Section 263 extends to the "*cost* of acquisition." 26 C.F.R. 1.263

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*This Court in *Commissioner* v. *Lincoln Savings & Loan Ass'n*, *supra*, suggested alternatively that where Section 263 by its literal terms might not apply, the principle of capitalization—deeply rooted in a tax system which requires accounting methods to "clearly reflect income" (Section 446)—would nevertheless bar a deduction. At least in this case, that analysis produces the same result as the expansive reading of Section 263 which we urge here. Both approaches reflect the view that accounting principles and economic substance should govern the capitalization question in the absence of clear statutory authority or fundamental tax policies to the contrary. For that reason, we also agree that even capital items which could not fairly be characterized as "amount[s] paid out" are nevertheless nondeductible and must be capitalized—that, in short, as this Court stated in *Lincoln Savings* (403 U.S. at 358), Section 263 "does not provide a complete list of nondeductible expenditures." However, we need not reach that question in this case for, as we proceed to show, construction-related depreciation is in fact an "amount paid out" for purposes of Section 263.

(a)-2(a) (emphasis added). This expresses the administrative understanding that the statutory phrase "amount paid out" is used synonymously with "cost incurred." Moreover, the Internal Revenue Service has consistently taken the position that construction-related depreciation must be capitalized and is not immediately deductible. See Rev. Rul. 59-380, 1959-2 Cum. Bull. 87; Rev. Rul. 55-252, 1955-1 Cum. Bull. 319. This position has been consistently sustained by those courts charged with a special responsibility for interpreting and applying the federal tax laws. *Coors* v. *Commissioner*, 60 T.C. 368; *Southern Natural Gas Co.* v. *United States*, 412 F. 2d 1222 (Ct. Cl.); *Producers Chemical Co.* v. *Commissioner*, 50 T.C. 940; *Brooks* v. *Commissioner*, 50 T.C. 927, reversed on other grounds, 424 F. 2d 116 (C.A. 5); *Missouri Pacific R. Co.* v. *Commissioner*, 22 B.T.A. 267; *Gulf, M. & N.R. Co.* v. *Commissioner*, 22 B.T.A. 233, affirmed as to other issues, 71 F. 2d 953 (C.A.D.C.); *Chicago, R.I. & P. Ry. Co.* v. *Commissioner*, 13 B.T.A. 988, reversed as to other issues, 47 F. 2d 990 (C.A. 7); *Great Northern Ry. Co.* v. *Commissioner*, 8 B.T.A. 225, affirmed, 40 F. 2d 372 (C.A. 8), certiorari denied, 282 U.S. 855.[1]

But even if the statutory phrase "amount paid out" were given its most literal construction, the cost

[1] The court of appeals below cited *Great Northern Ry. Co.* v. *Commissioner*, 30 B.T.A. 691, as permitting a current deduction for construction-related depreciation. In that case, however, the Commissioner had not argued that the construction costs should be capitalized. 30 B.T.A. at 708. See Pet. App. 17-18.

of the automotive construction equipment used by respondent was "paid out" to the same extent as the cost of all other supplies and equipment and the wages of construction workers. Respondent properly has never claimed that it could deduct, rather than capitalize, the cost of materials purchased in one year but wholly consumed in construction activities during another. Yet construction-related depreciation stands on precisely the same footing.

When respondent purchased its automotive construction equipment, amounts were "paid out" in the form of a purchase price; depreciation is simply a means of allocating those amounts over several accounting periods. The only question here is whether those amounts, to the extent allocable to construction activities, should be capitalized as part of the costs of construction. That question is answered by the language of the statute; "[a]ny amount paid out" in connection with the acquisition or construction of capital facilities must be capitalized, and the amounts represented by construction-related depreciation were paid out, in a very real sense, for the construction of such facilities. As the Tax Court stated in *Brooks* v. *Commissioner*, *supra*, 50 T.C. at 935, "depreciation—inasmuch as it represents a using up of capital —is as much an 'expenditure' as the using up of labor or other items of direct cost."

In concluding that depreciation does not represent amounts paid out within the meaning of Section 263, the court of appeals incorrectly relied upon cases disallowing deductions for depreciation under Sections 170 and 213, relating to charitable contribu-

tions and medical expenses.[8] Section 263 makes no reference to the timing of the actual payment; the emphasis of that statute is on the ultimately capital nature of the expenditure. But in enacting deductions for charitable contributions and medical expenses, Congress was obviously concerned primarily with cash-basis taxpayers and actual outlays of cash or other property. Thus Section 170 allows a deduction only for a "charitable contribution * * * *payment of which is made within the taxable year*" (emphasis added), and Section 213 limits the medical deduction to "expenses *paid during the taxable year*" (emphasis added). This insistence upon actual payment during the particular year is inconsistent with a purpose of allowing a deduction for depreciation, which represents not a current payment but an allocation on account of an amount previously paid.[9] Thus the Tax Court in *Producers Chemical Co.* v. *Commissioner*, *supra*, 50 T.C. at 959, involving depreciation incurred in connection with the acquisition of a capital asset, distinguished the medical expense case relied upon by respondent here (see note 8, *supra*) in the following terms:

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[8] The court cited *Orr* v. *United States*, 343 F. 2d 553 (C.A. 5) (charitable contribution), *Mitchell* v. *Commissioner*, 42 T.C. 953 (charitable contribution), and *Gordon* v. *Commissioner*, 37 T.C. 986 (medical expense).

[9] Of course, depreciation taken during the year of purchase does represent an amount paid during that year. But Congress may not be supposed to have capriciously intended Sections 170 and 213 to create a special allowance for depreciation limited solely to the year of purchase.

> [In that case, we] held that the deduction for medical expenses was for such expenses paid in the year for which the deduction was claimed and concluded that depreciation was not an expense paid in the year in issue. That case has no relevance to the issue in the instant case.

Moreover, Congress in Section 167 has restricted the depreciation deduction to income-producing assets. The courts therefore have properly resisted efforts by taxpapers to obtain deductions for depreciation on nonincome-producing assets under color of Sections 170 and 213.

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

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